DIAMOND JEWELLERY RETAIL

2013 SNAPSHOT

Diamond jewellery retail is a highly fragmented sector with over 200,000 retail doors selling diamond jewellery worldwide.

The past few years saw a marked contrast between developed and emerging markets in the performance of diamond jewellery retailers. In developed markets, retailers have faced pressures from a weak economic environment and strong competition from branded luxury goods and experiential categories, as well as the low-price models of ecommerce companies. On the other hand, the growing middle classes and increasing consumer appetite for diamonds have allowed retailers in developing markets, together with the less prevalent ecommerce models, to enjoy higher margins and return on invested capital, although these too have started to come under pressure.

DEVELOPED MARKET RETAILERS ARE UNDER PRESSURE, BUT SOME BUSINESS MODELS PERFORM STRONGLY

In developed markets, multiple business models exist within diamond jewellery retail, ranging from luxury chains to small, independent, family-owned stores. Many of the large listed retailers across the US, Japan and Europe have failed to meet their cost of capital, resulting in negative returns[4] (see Fig. 9). Leading US speciality jewellery chains closed over 2,000 doors in the last five years, with several traditional large chains such as Whitehall, Friedman's and Finlay no longer trading[5] (see Fig. 10). No new jewellery retail chains of scale have emerged to replace the doors lost when these stores ceased to trade.

Not all developed market retailers make returns below their weighted average cost of capital (WACC). Among several retailers that have established successful business models is Tiffany, which maintains one of the highest margins of its peer group[6]. Blue Nile is another example: the company is unusual in achieving negative working capital by minimising inventory and maximising payables, as consumers pay for their items before they have been acquired by Blue Nile[7].

JUAN G AUNION/SHUTTERSTOCK.COM

FIG. 9: **FINANCIAL RATIOS FOR A SELECTION OF LISTED JEWELLERS IN DEVELOPED MARKETS**

Per cent

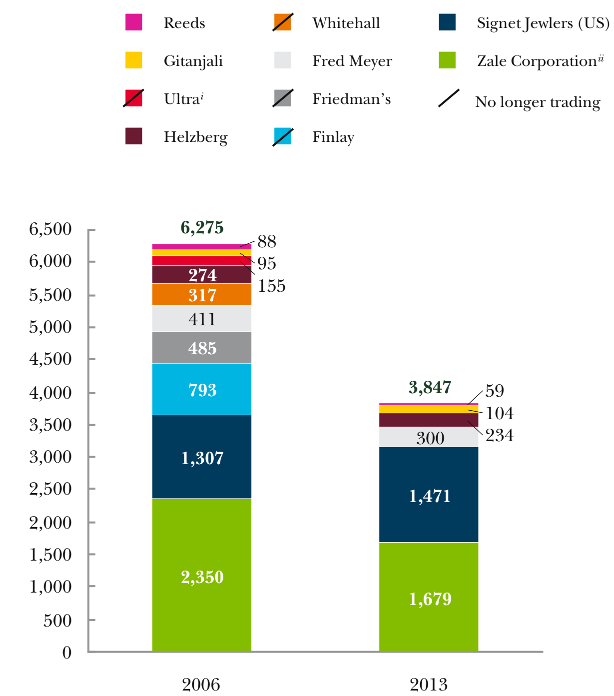
		ROIC 2012	Most recent	EBIT 2012	Most recent
US	Tiffany	19	15	18	21
	Signet Jewelers	15	15	14	14
	Zale Corporation	5	7	1	3
	JC Penney	-2	-13	-11	-10
	Blue Nile[i]	54	40	3	3
JAPAN	Tasaki Shinju	-2	5	-3	1
	Jewelry Tsutsumi	3	3	13	13
EUROPE	Damiani	-6	-5	-5	-4

i Blue Nile's 2013 annual report states that the company has negative working capital

Source: Bloomberg

FIG. 10: **UNITED STATES JEWELLERY CHAINS' DOORS OVER TIME**

Chains ranked top 10 in 2006



i Signet Jewelers acquired Ultra in 2012, with stores now incorporated in Signet Jewelers' (US) total

ii Signet Jewelers acquired Zale Corporation in 2014

Source: Company filings

FIG. 11: **FINANCIAL RATIOS FOR A SELECTION OF LISTED JEWELLERS IN EMERGING MARKETS**

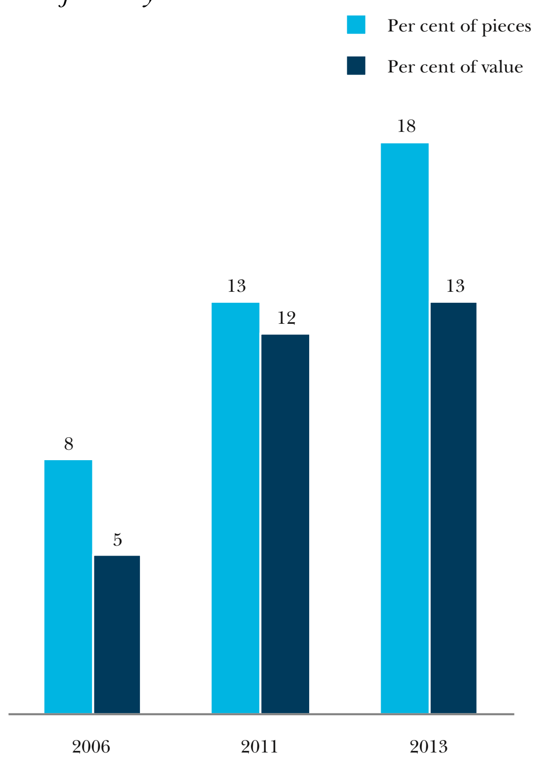
Per cent

		ROIC 2012	ROIC Most recent	EBIT 2012	EBIT Most recent
CHINA	Chow Tai Fook	15	14	13	12
	Chow Sang Sang	7	7	7	4
	Luk Fook Holdings	19	22	11	12
	Lao Feng Xiang	14	15	5	4
	Hengdeli Holdings	10	8	11	8
INDIA	Titan Company	35	22	10	10
	Thangamayil Jewellery	12	1	5	1
	Tribhovandas Bhimji Zaveri	12	8	9	7

Source: Bloomberg

FIG. 12: **GROWTH OF ONLINE DIAMOND JEWELLERY SALES IN THE UNITED STATES**

Share of online acquisitions in total women's diamond jewellery market



Source: De Beers

ON THE WHOLE, EMERGING MARKET RETAILERS HAVE OUTPERFORMED DEVELOPED MARKETS

For retailers in emerging markets such as China and India, sales of gold and gold jewellery, normally a low margin category, represent the majority of their revenues. However, retailers in these markets selling diamond jewellery have benefited from structural factors: growing economies, an increasing base of consumers with appetite for diamonds and expanding number of stores selling diamond jewellery. In China, there is also a benefit from relative sector consolidation, with multiple jewellery retailers operating 'at scale'.

Over the past few years, however, EBIT margins (which for the major listed developing market jewellers are similar to those of leading developed market peers) have come under pressure[8] as jewellery input costs have increased and the pace of expansion has slowed (see Fig. 11). In addition, gold demand volatility has also played a role in weakening financial results. As economic growth decelerates in the next few years, and competition increases, it is likely that margin pressures will also build for diamond jewellery retailers in emerging markets.

THE IMPORTANCE OF ONLINE CHANNELS RISES ACROSS THE WORLD

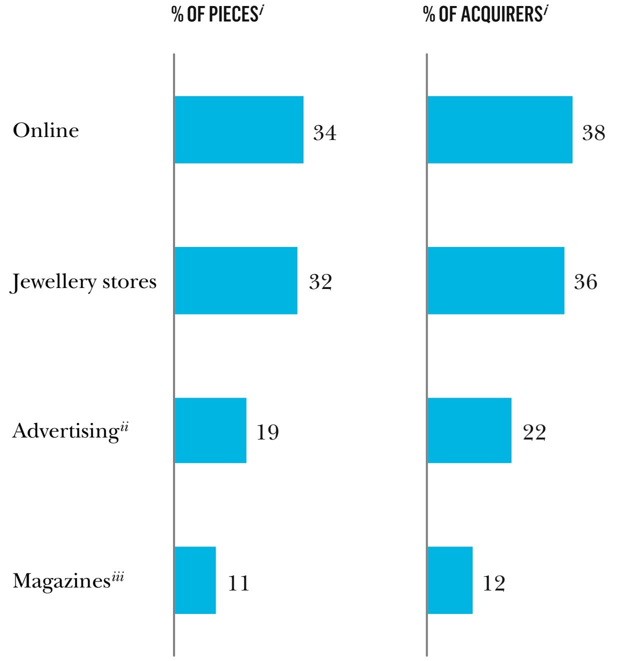
Both emerging and developed markets saw a rise in the importance of online channels in 2013. More than one in six diamond jewellery purchases in the US were made online in 2013, a growth of over 30 per cent since 2011 (see Fig. 12). Going online also remains the most popular way for consumers to research a purchase in the US: almost four in 10 consumers go online for research purposes before buying, ahead of other touch-points such as jewellery stores and advertisements (see Fig. 13).

Although online is not yet a significant sales channel in China, the internet is already used by a quarter of acquirers for different purposes, such as to learn about fine jewellery quality and prices, to learn about brands, and to pre-select designs. The internet is used more frequently in the diamond purchase process by single women, half of whom use it, and also by affluent consumers, about six in 10 of whom research online.

Online, including mobile usage, can be expected to grow in importance for diamond jewellery retailers everywhere, be it for research purposes before a purchase or as a sales channel (pure or hybrid, via web sales with store pick-up).

FIG. 13: **PRE-PURCHASE TOUCH-POINTS FOR DIAMOND JEWELLERY ACQUIRERS IN THE UNITED STATES**

Per cent of acquisitions in 2013



i Multiple responses allowed
ii Includes all forms of advertising for a piece of diamond jewellery or brand
iii Refers to DJ acquirers who selected 'look in magazines to see the range of options'

LOOKING AHEAD

BRANDS MAY HELP OVERALL PERFORMANCE, ESPECIALLY IN DEVELOPED MARKETS

One way for the retail industry to improve its financial performance could be a greater emphasis on branded diamonds and diamond jewellery. Increasing consumer preference for brands is evident in the US from the jump in claimed acquisition of branded engagement rings, from just seven per cent of consumers in 2002 stating that their diamond engagement ring (DER) was branded to one-third of consumers in 2013 claiming that this was the case.

By offering brands with a specific positioning, and a story that goes beyond the 4Cs, retailers are able to address consumer needs for emotional engagement, differentiate the product from generic offerings and reinforce the diamond dream. While scale companies are better placed to make the level of investment required to benefit from this growing preference, all retailers have the potential to benefit from this trend.

Branded diamond jewellery can also be an attractive financial proposition for retailers. Successful brands typically command a price premium above generic products. This is based upon factors such as polished diamonds' beauty and appearance, jewellery design, higher levels of consumer confidence, and superior service, offering retailers opportunities to differentiate from generic propositions (see Fig. 14).

The additional revenues from brands help retailers to invest further in the in-store experience and in promoting their businesses and the category, helping to generate growth.

GLOBAL LUXURY BRANDS ARE SUPPORTING THE DIAMOND DREAM AND CHANGING CONSUMER EXPECTATIONS

Many global luxury players such as Chanel and Dior have entered the market for diamond jewellery, and their approach to retailing is raising the bar for all (see Fig. 15). As consumers become accustomed to the retail standards set by the luxury houses, their expectations of the store environment and customer service are rising – with important consequences for other fine jewellery retailers.

Global luxury companies are not only changing consumer expectations of how to buy, but also consumer beliefs about what to buy. When selecting diamonds, a consumer's focus is often on acquiring the best diamond possible: the carat content and quality are critical. Global luxury brands are often trying to shift the focus towards acquiring distinctive designer pieces, adorned with diamonds.

FIG. 14: HOW THE FOREVERMARK BRAND IS SUPPORTING RETAILERS

1 OFFERING A UNIQUE PROPOSITION

- Fewer than one per cent of the world's diamonds are eligible to become a Forevermark diamond.
- Branded diamonds with strong consumer benefits can command a price premium over unbranded products, translating into a margin uplift.
- Forevermark provides retailers and consumers alike with the total confidence that their Forevermark diamond is not only natural and untreated but responsibly sourced.
- Retailers can utilise the Forevermark brand in designs tailored to specific markets and consumer tastes. *"I also love the fact that, while Forevermark is a brand in and of itself, we are able to customise the offering and the marketing message to fit our merchandise and image strategies."* – Coleman Clark, B.C Clark Jewelers.

2 INVESTING IN AWARENESS AND DRIVING FOOTFALL AS CONSUMERS SEEK OUT FOREVERMARK STOCKISTS

- Launched in China in 2008 and North America in 2011, Forevermark now has over 476 and 402 retail partners in the countries respectively.
- The Forevermark brand continues to make gains in brand awareness in the top diamond jewellery markets: in 2013, prompted awareness in the US reached one third of consumers, and in China prompted awareness was 44 per cent.
- Forevermark recently celebrated its one millionth inscription globally, with 45,000 diamonds inscribed in the US in 2013, a year-on-year increase of 66 per cent.
- The Forevermark US Center of My Universe campaign in 2012 and 2013 was enthusiastically received by both consumers and retailers: *"...very pleased with overall traffic that was brought in due to the campaign. Three times better than last year's."* – Forevermark retailer.

3 ENHANCING THE PURCHASING EXPERIENCE FOR CONSUMERS

- Consumer initiatives such as branded in-store diamond viewers enhance the consumer's experience, creating a dialogue around the product. *"Getting a client involved in viewing the Forevermark icon and inscription number is a must."* – John Borghes, Marci Jewelers.

Source: De Beers

FIG. 15: **CASE STUDY: CHANEL**

Chanel is an example that epitomises the level of sophistication that luxury retail has reached.

"If I have chosen diamonds it is because they represent the highest value in the smallest volume"
– Gabrielle Chanel

MARTIN GOOD/SHUTTERSTOCK.COM

The brand has invested heavily in stores, securing prime locations for its flagships, (eg New Bond Street in London and New York's Fifth Avenue). Additionally, the quality of materials and architecture of these stores is rising fast: leading architect Peter Marino was engaged to work on Chanel's flagship New Bond Street store in London, and this one store alone is estimated to have cost £30 million to design and refurbish[9]. Chanel has also created pop-up stores, such as its temporary boutiques in St Tropez[10] and Courchevel[11], aimed at attracting wealthy holidaymakers.

MARCH MARCHQ/SHUTTERSTOCK.COM

Chanel has been careful to differentiate its store formats, opening specialist boutiques exclusively to serve customers who are shopping for fine jewellery and watches rather than fashion. This allows Chanel to offer an experience tailored specifically to selling jewellery, with the right store ambience, specially trained staff and accompanying security.

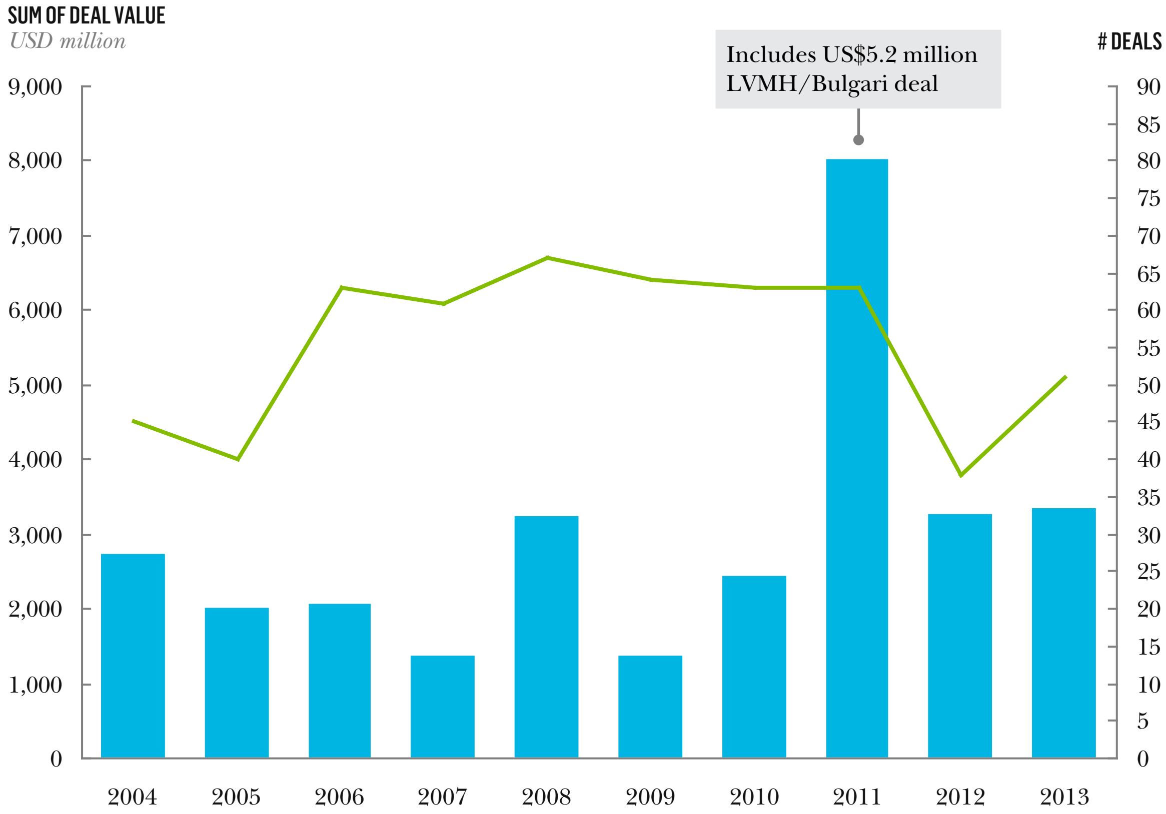
RADU BERCAN/SHUTTERSTOCK.COM

Chanel is using technology and data in innovative ways to enhance the customer experience. For instance, new stores feature a large screen on which to stream live coverage of Chanel's fashion shows. Chanel also communicates with its customers through a twice-daily newsletter, Chanel News[12].

TK KURIKAWA/SHUTTERSTOCK.COM

At the same time as investment in store and customer experience has grown, Chanel's marketing investment has also risen (as has that of its peers in the luxury world). Chanel more than doubled its overall advertising spend over the last five years (up from US$67 million in 2008 to US$153 million in 2013), pulling ahead of branded jewellery specialists whose advertising spend decreased over the same period[13]. This level of investment, in both advertising and the retail experience, helps to reinforce the consumer's desire for diamonds as precious and beautiful gems that are particularly appropriate to mark significant life occasions and milestones.

FIG. 16: **JEWELLERY MARKET M&A VOLUMES AND NUMBERS OVER TIME**



Source: Dealogic

CONTINUED CONSOLIDATION CAN BE EXPECTED

A possible response to rising consumer expectations, and the increased investment required to support them, could be retailer consolidation. In fact, given the recent weakness in the world's economy and the number of underperforming retailers, consolidation might already have been expected to happen.

In reality, deal numbers and volumes in the industry have grown slowly, at only two per cent CAGR from 2003 to 2013[14] (see Fig. 16).

The recent transaction announced between Zale Corporation and Signet Jewelers in the US may signal a change in the US jewellery retail space. The new combined Signet/Zale entity could have as much as 10 per cent of total diamond jewellery sales in the US. The US$100 million of annual savings estimated to be achieved by fiscal year-end 2018[15], which the new entity hopes to generate through store rationalisation and increasing buying power, are meant to support its profitability and allow it to invest in responding to the changing consumer landscape.